LEGITIMATE CONCERN & SOME PERSPECTIVE

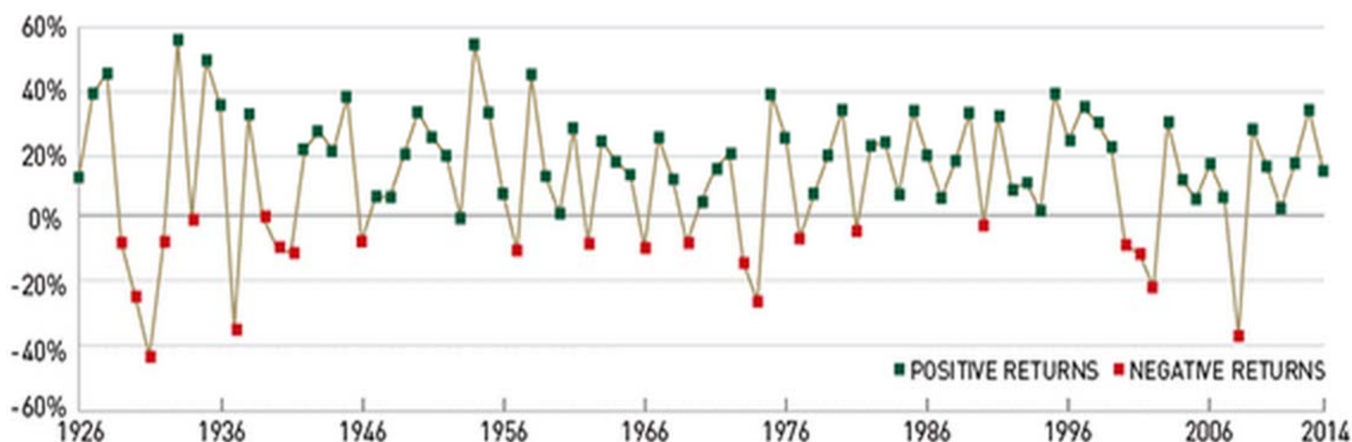
NOT FIGHTING THE FED

Last quarter, I mentioned that I would discuss a powerful, 48–year study that found a number of interesting relationships between Federal Reserve policy and the performance of various types of assets. Due to recent volatility in the capital markets, however, I would like to address this topic some other time.

MARKET FLUCTUATIONS ARE NORMAL

Before I address the dismal returns generated by capital assets so far this year, I would like to stress that disappointing years are a normal part of the investment process as shown here.

Annual total returns for S&P 500 Index, 1926–2014



Historically, corporate profits have tended to increase and those increases have tended to show up in the form of positive equity returns. Of all the dots that appear above, about three-quarters of them are green. Extrapolating historical trends is often a recipe for wrongness, but multi-year winning streaks have occurred far more frequently than losing ones.

OFF YEAR

2015 is obviously shaping up as an off year. Through the first 9 months of the year, large-company stocks here and abroad are down in the mid-single-digit range.

Small-company stocks in this country have traded lower by almost 8%. Stocks of emerging-markets countries are down by about twice as much and commodities are off by around 20%. As might be expected, various fixed-income categories have held up better. So far this year, returns generated in the U.S. bond market are marginally positive. We remain positioned for rising interest rates because the risk of not being positioned this way seem to far outweigh any potential reward.

In general, investors are fretting over slowing growth in China and in other parts of the world. Oddly, investors became unnerved when the Federal Reserve chose to *not* implement its first anticipated interest-rate hike in many years. Apparently, investors took it as a sign that the Fed had doubts about the health of the U.S. economy. In my opinion, a more correct read would have been to conclude that the Fed factored in emerging stresses in the global economies and concluded that it would prefer to not add to those stresses yet.

ACTUAL RETURNS HEAVILY INFLUENCED BY TIMING DECISIONS

Dalbar, a financial services consulting firm, recently released a study comparing the returns officially reported by equity-oriented mutual funds to the returns *actually* experienced by investors who invested in such funds.

If you're wondering how it's possible for the returns reported by funds to differ from the returns actually experienced by the folks who invested in them, consider a scenario where a fund generates a 100% return one year and a 20% loss the next. The fund would properly report a compounded annual return of +26.5% for that 2-year period, but depending on *when* or *how heavily* investors happened to invest in that fund, the returns they actually experience are likely to vary widely.

BAD DECISIONS AT CRITICAL POINTS

Not all decisions to invest are market-timing related, but obviously, a rational investor would prefer to be invested when positive returns are there for the taking, and to sit on the sidelines when they're not. The trick is knowing which time is which. So, how did investors do?

Over the past 30 years, Dalbar found that equity funds posted average annual returns

of 11.1% while the returns that were actually experienced by investors amounted to only 3.8% per year. That is, equity fund investors captured average returns of 3.8% per year even though returns of 11.1% per year were available to them. Dalbar chalks the discrepancy up to "bad investor decisions at critical points."

EMOTIONAL INEPTITUDE MAY BE OVERSTATED

For a variety of reasons that are too abstruse for this letter, the results of studies like this are likely to generate skewed results due to the uniqueness of the period being studied. I am also certain that at least some of the returns that investors failed to capture were for reasons other than poor timing decisions. Nonetheless, I am convinced that, on average, emotions detract from the investment decision-making process.

MARKET TIMING — ANOTHER STUDY & A FEW MORE THOUGHTS

Charles Schwab studied this issue a couple of years ago, as well. Although this study was aimed at folks who were not yet retired, it analyzed 68 distinct, 20-year periods and concluded that perfect timing did not help returns by as much as poor timing hurt them. In short, Schwab favors remaining invested (big surprise, I know). I have a few thoughts on the matter, too:

- People tend to shun capital assets when the investment environment is especially unsettled. Unfortunately, those are the times attractive buying opportunities are most likely to present themselves. Historically, the cost of feeling safe is reduced returns.
- People will trample each other to buy a stuffed animal the day after Thanksgiving, but when capital assets go on sale, investors often want to unload theirs, too.
- Performance claims made by market timers may be based on *hypothetical* returns that have been derived from *historical* data instead of actual portfolio results.
- Stock, bond, and commercial real estate markets have historically been positive-sum games where, on average, winnings are improved by staying *in* the game.
- Returns from stocks have tended to come in concentrated lumps that occur at unexpected times. Being on the sidelines increases the odds of missing those lumps.

- Many of the “signals” that capture market timers’ attention are meaningless noise. Ignore them the same way you would ignore tape hiss and TV snow.
- Every market downdraft over the past 90 years has been followed by an updraft of equal or greater magnitude.

OF PSYCHICS AND MARKET TIMERS

Psychics know that making more predictions increases the odds of getting at least something right. The fact that they get it wrong most of the time is unimportant because they know their customers are more tuned into their “hits” than their “misses.” Market timers and prognostication gurus rely on this same psychology to their advantage.

I feel like I could pick on almost any seer and wind up with the same result, but I’d like to shine a little light on Dr. Nouriel Roubini, aka “Dr. Doom,” since he has garnered so much fame for having predicting the meltdown of 2008.

There’s some question as to whether he actually did make this prediction, but he did predict a global recession would start sometime during the preceding four years. It didn’t. At the depth of the collapse in 2009, he predicted stock values would fall 12% further. They didn’t fall at all. After stocks recovered markedly over the next few weeks, he characterized the recovery as “unsustainable.” So far, that unsustainable recovery has lasted more than six years. When stocks temporarily sagged in July of 2009, Roubini warned that no bottom had been reached yet, but that’s exactly what it turned out to be. Market predictions are like miracle cures. They draw attention because people hope they’ll work, not because they do.

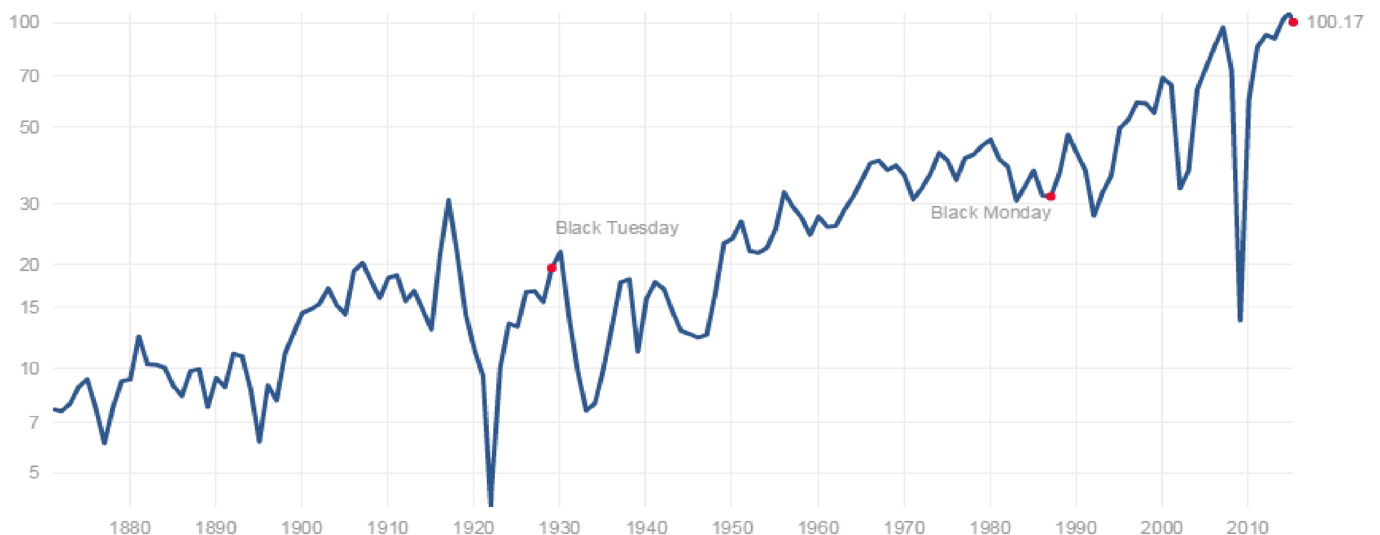
INVESTOR TWITCHINESS

It makes sense for schools of fish to dart back and forth because it reduces their individual odds of becoming lunch. Investors exhibit similar herd mentality, but unlike fish, they do it to their own detriment (as shown by Dalbar). Because investors are often unable to gauge the value that resides within their portfolios, they are forced to rely on their monthly statements, over-confident media personalities, and other external sources, all of which are subject to wild swings in sentiment. The predictable result is a lot of investment noise and perpetual investor twitchiness.

SENSE OF VALUE ... THE PSYCHOLOGICAL ANCHOR

The value intrinsic to most any investment is likely to be tied, in some way, to the cash flows it produces and to the rate at which those cash flows are expected to grow. The more quickly they grow, the more attractive the investment. Dividends are similar to cash flows. Notice how their annual rate of growth has varied over the years.

Few investment instruments are routinely capable of rewarding their investors with double-digit cash flow increases every year. From where do these increases come? Corporate earnings. The journey has been lumpy, but the destination has been good.



I don't know where stock values will be 3—5 years hence, but because investment value is derived largely from cash flows and because cash flows tend to increase over time, I would expect stock valuations to increase, as well. The real issue, then, is whether those cash flows actually will increase fast enough to keep folks happy.

Over the past 10 years, dividend-paying stocks in the portfolios we oversee have increased their payout rates by an average of 11.7% per year. Over the last five years, that figure is 14.8%. (Bear in mind that that 10-year figure *includes* the meltdown of 2008/9!). But still, the future is what matters, so let's take a look.

THIS IS THE THING THAT CAUSED THE SCARE THAT AWAKENED THE BEAR THAT RUINED THE HOUSE THAT JACK BUILT

Maybe. The last chart showed that corporate earnings are at a historically high level, but this chart indicates the rate at which those earnings are *growing* has stagnated.

S&P 500 Earnings Growth Rate

Since earnings beget cash flows and cash flows beget dividends, a slowdown in the rate of earnings growth is likely to show up as an eventual slowdown in the rate of cash flow and dividend growth. Will they slow? I don't know. No one does. Let's see how Zacks Research sees things.

SQUINTING INTO THE FOG WITH ZACKS RESEARCH

As it happens, Zacks publishes a forecast of future asset class returns every month. I've lifted a few opinion tidbits from its October edition on a range of topics that could be of interest:

- **The Bull Market in the U.S.** — The U.S. bull is old, but not dead … this is a traditional valuation correction … maintain a long-term perspective.
- **Economic Expansion in the U.S.** — 2.5% expansion for U.S. GDP remains our base case … [we think the economy will] muddle through.
- **Interest Rates** — [Stimulus in Europe will] keep global long-term rates low [resulting in] a tailwind for U.S. stocks.
- **Health Care Sector** — [It's] still a dominant sector. (This is good news for us because most of our portfolios are well represented in this area.)
- **GDP in Europe** — Stronger European GDP growth in the second half of 2015 remains the consensus.
- **Corporate Bonds** — [They] offer the best coupons … however, [expect total returns of] only 3.5% to 4.5% [per year].
- **The Pullback in Stock Valuations** — [Negative sentiment is] tied to [the] China worry even though only 10% of S&P revenues [are derived from] Asia.
- **U.S. Stock Valuations** — A 6.15% earnings yield [suggests] undervaluation … [assuming] 2016 earnings forecasts hold up, [but the] fundamental trend is NOT healthy!" Translation: Zacks remains optimistic, but acknowledges current trends to the contrary. It finishes by encouraging investors to "stay positive about 2016 earnings per share fundamentals."
- **Estimated Average Annual Return Potential from U.S. Equities over the Next 3 to 5 years** — For small stocks, it builds a case for average annual returns to be in the range of 9.8% — 13.2%; For larger stocks, its guess is 8.4% — 9.8% per year.

NONE OF THAT SOUNDS TOO SCARY, BUT THIS DOES

Former Treasury Secretary, Larry Summers, has weighed in on the recent slowdown in global economic activity. In short, he fears the industrialized world has lost its ability to grow at satisfactory rates despite widespread help from the world's central banks. He sees the potential for slow growth in industrialized and emerging markets to feed on one another in a vicious feedback loop.

He believes that policymakers are badly underestimating the risks of both a return to recession in the West and of an enduring period where global growth is unacceptably slow. He also frets that if a recession were to occur, persistently low interest rates would impair monetary policymakers' ability to respond effectively.

Mr. Summers notes that global growth forecasts have been revised sharply downward almost everywhere and that, relative to its 2012 forecasts, the International Monetary Fund has reduced its 2020 GDP forecast by 6% for the U.S., 3% for Europe, 14% for China, 10% for the emerging markets economies, and by 6% percent for the world as a whole.

Because the global economy is shuffling along near what he characterizes as "stall speed," he sees recession as a primary threat. The remedy, he believes, may be found in higher government spending throughout the world. He argues that because borrowing costs are so low, countries can afford to take on a higher levels of debt than were once thought prudent. In terms of comparing the pain of a global recession to that caused by widespread budget deficits, he regards the resulting budget deficits to easily be the lesser of two evils.

Finance officials from the world's 20 largest economies are meeting in Peru as I write this. If they agree with Mr. Summers, they're in position to address the issue.

Larry Summers is an insightful fellow whose views are worth heeding. However, I also respect Milton Ezrati, Chief Economist for Lord Abbett mutual funds, who regards equities in at least portions of the emerging market countries to be attractive.

All our portfolios are well diversified, so hang in there. — Glenn Wessel